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SUBJECT: SUBMARINE PURCHASE SPARKS DEBATE IN PORTUGAL

Classified By: Pol-Econ Officer Mario Fernandez,
reasons 1.4(b) and (d)

¶1. (C) Summary. The Portuguese prosecutor's office filed fraud charges September 30 against seven Portuguese and three Germans involved in the controversial one billion Euro purchase of two German-built diesel submarines for the Portuguese Navy, sparking debate about whether Portugal needs -- or can afford -- the top-of-the-line submarines and raising expectations that the Portuguese government may renegotiate the deal. While full details have yet to emerge and the legal process has just commenced, the prosecutor's office alleges that the German Submarine Consortium conspired with Portuguese companies to include as offsets business that already existed, double-invoiced certain offsets, and in some cases reported costs far above the invoice price, defrauding the GOP of approximately 34 million Euros. To date, no GOP officials have been charged.

¶2. (C) Although the unfolding scandal is unlikely to derail the purchase this late in the decade-long process -- one of the submarines is now undergoing sea trials -- the sobering price tag, which came due during a recession, has some government officials second guessing the purchase and finger pointing across the aisle, with the former Speaker of Parliament saying that Portugal "does not need the submarines at all" and "urgently needs to sell" them to acquire more useful weapons. While the submarines are not inconsistent with Portuguese national maritime strategy -- Portugal has had submarines since 1913 -- Post believes an enhanced maritime patrol capability, such as surface patrol vessels, would be a more efficient use of Portugal's limited defense budget. End Summary.

BACKGROUND

¶3. (SBU) Since the late 1990s, the Portuguese Ministry of Defense had been interested in replacing its last operating Cold War-era submarine -- commissioned in 1968 -- by 2010. The acquisition was controversial from the beginning and was hotly debated in Parliament, proponents arguing that Portugal, with its maritime history, required the submarines to protect its vast maritime territory while opponents countered that a country of 10 million could not afford them. In the end, Parliament approved the purchase and, in 2003, the Portuguese government -- then led by the center-right Social Democrats (who are now in opposition) -- put out for bid a contract for two diesel submarines. While companies from five European countries submitted bids, the GOP selected a proposal from a German consortium as best in price, offsets, and operational capability.

¶4. (U) In April 2004, the GOP signed a contract with the German Submarine Consortium, an enterprise composed of the two German yards with experience in making submarines, for the construction of two specialized diesel submarines at a

cost of over 800M Euros (approximately 960M USD in 2004), with an option for a third. The parties agreed, however, that the German Submarine Consortium would provide trade offsets, such as the creation of industrial projects in Portugal, worth 1.21 billion Euros. As is customary, the offsets were specified in a separate, not publicly available, contract. (Note: An "offset" is a contract mechanism by which the buyer requires the seller to reinvest a portion of the contract price in the buyer's economy. They can take many forms, including co-production, subcontractor awards, technology transfer, and local investment.) With the first of the two submarines conducting sea trials and scheduled to arrive in Portugal in spring 2010 and the second in spring 2011 -- Portuguese crews have been training in Germany for some time -- the Portuguese prosecutor's office filed charges September 30 against seven Portuguese and three Germans involved in the deal for forging contract documents and defrauding the GOP out of approximately 34M Euros.

CUSTOM BUILT SUBMARINES; INFERIOR TORPEDOES

15. (C) The Portuguese Navy has been operating submarines since 1913, when it purchased its first three submarines from Italy. In 1964, Portugal bought four diesel-electric attack submarines from France (Daphne Class). Of these, only the Barracuda, commissioned in 1968, remains operational -- though there are growing concerns about its safety given its age -- and is used for training exercises and counter-smuggling operations. The two new German Class 209 submarines -- one named Tridente, the other Arpao ("Harpoon") -- would give the Portuguese Navy the capacity for defense

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and law enforcement patrol. It should be noted that the GOP caused increases in the price by specifying upgrades to the base 209 design, with features from the newer Class 214 submarines.

16. (C) Similarly, the GOP's choice of torpedoes to equip the submarines was problematic. While the six torpedo tubes in each sub could be armed with the U.S. Mark 48, the GOP purchased 24 Italian "Black Shark" torpedoes, considered less capable, less reliable and, at a cost of approximately 2.8M USD per unit, 12 percent more expensive than the Mark 48. The GOP decision was almost certainly driven by EU pressure to buy European.

PROSECUTOR'S OFFICE FILES CHARGES

17. (U) As early as 2007, rumors began to surface that the Portuguese Judiciary Police were investigating a 24M Euro transfer from the German Submarine Consortium to a Portuguese company. On September 30, 2009, following a two-year investigation in Portugal and Germany, the Portuguese prosecutor's office filed charges against seven Portuguese managers and three German representatives from Man Ferrostaal, a company belonging to the German Submarine Consortium, for forgery and fraud. The Portuguese prosecutor's office alleged that they improperly benefited from the offsets program. Investigators estimated the GOP was defrauded of approximately 34 million Euros. The German consortium has denied the charges.

18. (U) While the prosecutor's office has yet to provide full details, the gist is that the representatives of the German Consortium conspired with Portuguese companies to include as offsets business that already existed, double-invoiced certain offsets, and in some cases reported costs far above invoice. In addition, the offsets appear to have increased the price of the submarines significantly. According to the prosecutor's office, the GOP paid five to fifteen percent more than necessary for the submarines to generate offsets for Portuguese companies. There were a number of red flags during the process, such as evidence that the German group

was informed they had won the bid three weeks before the Portuguese Minister of Defense signed the document making the decision official. The prosecutor's office is expected to file a second complaint, but no government officials have been charged and there is no indication any were involved in the scandal.

"PORTUGAL DOES NOT NEED THE SUBMARINES AT ALL"

19. (U) The unfolding scandal immediately sparked debate over the wisdom of buying the subs. The currently ruling Socialists (PS) were quick to point out that the contract was signed in 2004 by the Social Democratic (PSD) government then in power, when PSD leader Manuela Ferreira Leite was Minister of Finance. Former PS Speaker of Parliament Almeida Santos quipped that he might be a "bit of a donkey," but he failed to understand why Portugal needed the subs. "Portugal does not need the submarines at all," he said, adding that Portugal "urgently needs to sell the submarines" to acquire weapons more "useful and necessary." Predictably, then PSD Minister of Defense Paulo Portas, who signed the contract in 2004, denied the allegations, underscoring that they came from anonymous sources, were tied to the 2009 election season, and were a case of "history badly told."

110. (SBU) Defending the submarine purchase on October 15 during his annual state of the Navy address, Admiral Fernando Melo Gomes, Chief of the Portuguese Navy, spoke in generalities when he declared that Portugal could not "dispense with submarine weapons" and "cede to others its sovereignty and responsibility to intervene in maritime zones within the national interest." Noting that the purchase had been approved by the political establishment, Gomes concluded, "To have submarines is expensive, very expensive, but more expensive would be not to have them, especially for those generations that follow us."

PORTUGUESE NAVAL MARITIME STRATEGY

111. (SBU) The Portuguese Navy considers the vast triangular maritime area in the Atlantic Ocean delineated by Portugal, the Azores, and Madeira to be their neighborhood to defend and patrol. Under the Law of the Sea, Portugal actually has jurisdiction over a smaller area encompassing some 1.7 million square kilometers. According to Portuguese Navy

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maritime strategy, "that sea must be protected, surveyed, exploited, and defended, in order to safeguard national interests." Submarines can fulfill many maritime applications and can, in fact, be justified as contributing to the Portuguese Navy's dual defense and law enforcement mission. In addition to their defense function, submarines serve as discreet surveillance platforms that can be used to track suspicious vessels with illicit cargo. Proponents are hard-pressed, however, to articulate specifically why, other than their stealth, the submarines are more appropriate than other, cheaper platforms.

SIGNIFICANT OPPORTUNITY COSTS

112. (C) The problem with the submarines is not that they do not readily fit into Portuguese strategy; but rather, the purchase represents a missed opportunity to procure more urgently needed, and arguably more strategically useful, assets. As maritime threats to national security have decreased, the Portuguese Navy has been increasingly focused on its law enforcement mandate. Thus, a fleet of ocean-crossing surface vehicles might have been more appropriate. Similarly, the Portuguese Air Force needs helicopters to replace its twenty 1960s vintage helicopters, and to modernize avionics for its six C-130 transport aircraft. Finally, the submarines contribute little to

NATO's emphasis on deployable forces. As if to underscore, Embassy Lisbon is currently fielding a Portuguese request to borrow from the U.S. 25 Humvees for an infantry unit Portugal intends to deploy to ISAF in January 2010.

SUBMARINE COST WILL IMPACT DEFENSE BUDGET

¶13. (C) The submarine purchase will impact the 2010 defense budget. Though the 2010 budget has yet to be passed, assuming 2009 figures, the submarine purchase represents more than 50 percent of the defense budget, which itself constitutes 3 percent of the entire government budget. Further, the GOP did not include maintenance, training, salaries, and operating costs (including the torpedoes) in the purchase price. Combined costs will surely run into the tens of millions of Euros annually. At one point in 2008, press reports suggested that the GOP was entertaining the possibility of selling the submarines to Venezuela, though the GOP immediately denied the report. According to press reports, the Ministers of Defense and Finance were reportedly collaborating to solve the problem at that time, even as then Economic Minister Manuel Pinho was publicly criticizing the purchase as an "unnecessary expenditure."

¶14. (SBU) European Union rules provide that defense purchases be applied to the budget the year they become operational, regardless of whether the purchase will be financed over several years. The GOP may well be forced to play budgetary juggling to comply with EU rules. Because the GOP will receive one of the submarines in 2010 and the other the following year, the GOP may be able to split the cost over two years, softening the impact. In any case, the GOP appears unlikely to cancel the deal. Although the media have run unsourced reports that the government was considering nullifying or renegotiating the contract, the Permanent Commission on Offsets (a GOP Ministry of the Economy agency responsible for the implementation of Portuguese Offset Law), recently stated that it remained committed to comply with the Portuguese government's contractual obligations.

COMMENT

¶15. (C) The Portuguese are steeped in their seafaring history and feel an almost visceral pride in their maritime tradition and their past glory as a global empire. With their only submarine scheduled to be decommissioned in 2010, giving up the purchase of these two submarines would mean relinquishing all submarine capability. This sense of pride explains why a country of ten million people, a member of the NATO alliance facing no discernible maritime threat, would purchase such expensive submarines in the first place. While the unfolding scandal may have sparked public debate over the wisdom of the purchase, and some legal experts speculate that the fraud charges open the door to annul or renegotiate the purchase, the debate at this point is mostly academic. The GOP has given every indication that it will go ahead with the purchase and the Portuguese Navy continues to prepare to incorporate the two submarines into their arsenal. Post continues to maintain that an enhanced maritime patrol capability, such as multiple ocean-crossing surface patrol

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vehicles, might have been a more efficient use of Portugal's limited defense acquisition Euros.

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<http://www.intelink.sgov.gov/wiki/portal:portugal>
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